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4-1997

# Prudence or Paranoia?

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Bernhardt, Roger, "Prudence or Paranoia?" (1997). *Publications*. Paper 344.  
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**April 1997**

**Prudence or Paranoia?**

*ROGER BERNHARDT*

Many an unrecorded interest has been saved by the doctrine of inquiry notice. Suppose, for instance, that:

- *A* did not record his mortgage from *O*, but *O*'s later deed to *B* specified that it was "subject to *A*'s mortgage"; or
- *A* did not record his deed from *O*, but was in possession of the property.

In both cases, the doctrine provides that someone in *B*'s position who has actual notice of these suspicious circumstances has a duty to inquire about them, and if the inquiry would likely have led to discovery of the unrecorded instrument, then *B* will be charged with constructive notice of it. (This universal rule appears in statutory form in CC §19: "Every person who has actual notice of circumstances sufficient to put a prudent man upon inquiry as to a particular fact, has constructive notice of the fact itself in all cases in which, by prosecuting such inquiry, he might have learned such fact.")

**After Dispute Arises**

An attorney who represents *B* after a dispute has already arisen (*i.e.*, *B* bought or loaned without actual knowledge of *A*, but *A* claims that *B* should be charged with constructive notice under CC §19) has two possible arguments:

- that the circumstances were not sufficient to put a prudent person on inquiry; or
- that making the inquiry would not have led to learning the fact.

(A possible third defense—that *B* had no actual notice of the suspicious circumstances—is not too promising because a court could too easily hold that *B* should have known of the suspicious circumstances even if he didn't search the records or look at the property).

**Before Consummation of Transaction**

An attorney who represents *B* before a deal is made applies the statute differently:

- first, admonishing *B* to look at the records and the property and to report to her any unusual facts he encounters; and
- second, recommending a line of questioning for *B* to follow to learn more about those facts if she deems them suspicious.

If *B* thereby learns of *A*, he can withdraw or negotiate and avoid harm; if *B* does not thereby learn of *A*, he probably will prevail on the ground of lack of notice. Thus, an attorney who has her client make note of suspicious circumstances and then diligently inquire about them should in this way keep him safe—or so I thought until I read *In re Marino* (Dye v Rivera) (Bankr 9th Cir 1996) 193 BR 907, reported at 20 CEB RPLR 49 (Jan. 1997).

**Marino Case**

In *Marino*, Rivera lent Marino \$2.5 million to pay Tokai's \$2 million deed of trust and to give Marino \$450,000 cash. Apparently, some slight balance remained owing to Tokai, because its deed of trust got subordinated rather than canceled. Neither Rivera's deed of trust nor Tokai's subordination was recorded. Therefore, when Marino filed bankruptcy under Chapter 7, the bankruptcy trustee decided it could avoid Rivera's deed of trust under Bankr C §544(a)(3).

In order to exercise its strong-arm power to avoid the instrument, however, the trustee had to qualify as a bona fide purchaser without notice of Rivera's deed of trust. This the trustee could not do. The bankruptcy appellate panel held that "a prospective bona fide purchaser . . . would have inquired into the status of the Tokai note and discovered the . . . payment, the subordination agreement and the existence of Rivera's deed of trust. This would provide constructive notice." 193 BR at 910. Similarly, the court held: "Given the existence of the note and the large balance remaining, . . . a prudent purchaser would have inquired into the status of the Tokai note. . . . This inquiry would have revealed the existence of Rivera's . . . deed of trust and the fact that it was in first position, ahead of the Tokai note." 193 BR at 912.

### ***Marino* Implications**

Well, it may be wonderful that the bankruptcy trustee was defeated, but how realistic were the grounds for victory? How many real estate practitioners would have suggested that kind of inquiry to their clients? A crude survey among my peers revealed that all of us would have flunked. Prudent buyers certainly inquire about loan conditions, but the statutory precondition of "circumstances sufficient to put a prudent man upon inquiry" requires suspiciousness as well as self-interested curiosity (see *e.g.*, *Hobart v Hobart Estate Co.* (1945) 26 C2d 412, 159 P2d 958). Neither I nor any of my surveyed friends found anything suspicious in the fact that there was a recorded \$2 million deed of trust on the property. Recorded mortgages are considered the norm rather than a cause for concern or heightened diligence.

That *Marino* would have us reverse this attitude is not very significant, because attorneys do advise buyers and lenders to inquire about the condition of loans on the property, whether or not there is a duty to do so. What could be significant, however, is the *nature* of the inquiry *Marino* would have them make. *Marino* implicitly imposes a duty to ask whether the priority of a known recorded loan is not as it seems to be in the records, but is instead inferior to some unrecorded and unknown loan. I think it is safe to say that lawyers have not been advising that kind of inquisition. If the records show the bank has a first, we don't advise the client to ask the bank officer "but are you really a second behind an unrecorded first?" That's confusing nosiness with notice.

And would a bank officer really answer such a question? The beneficiary statement mandated by CC §2943 requires a lender to respond to a request for information only as to loan balance, arrearages, payments and payment dates, and similar information. The policy of the statute represents, I assume, a political accommodation between one side's need to know and the other side's burden of collecting and disclosing information. Priority is not one of the topics subject to such statutory interrogation. The new Restatement of Mortgages takes the same limited approach, stating that a lender should disclose the "nature and status" of its loan, but saying nothing about priority. Restatement (Third) of the Law of Property, *Security (Mortgages)* §1.6 (Council Draft 1994). (Dale Whitman, one of the Restatement's reporters, advises me that lenders opposed having to state what their priority was so as not to be estopped if their lawyers later claimed they were more senior than they had stated.)

Additionally, the statutory policy of encouraging recording by imposing sanctions on those who do not record would be measurably weakened if everybody else had to affirmatively investigate for all those claims not on the records. See *March v Pantaleo* (1935) 4 C2d 242, 48 P2d 29.

### **Observations**

Notwithstanding the above concerns, I don't believe that lawyers have to change their approach and really start advising buyers to explore the unknown. *Marino* was a bankruptcy case; there was no real buyer being penalized for not asking those bizarre questions, but only the

trustee, who was attempting, on the basis of the lender's "technical" blunder (*i.e.*, an unrecorded mortgage that harmed no one), to prohibit the lender from collecting \$2 million it had actually disbursed. Recent cases from the Ninth Circuit (notably *In re Weisman* (Robertson v Peters) (9th Cir 1993) 5 F3d 417 and *In re Probasco* (Probasco v Eads) (9th Cir 1988) 839 F2d 1352) appear to me to be significantly stretching the notion of inquiry notice in order to protect unrecorded claimants from the trustee's strong-arm predations. If that leaves us with a rule that says *hypothetical* buyers and lenders have to ask silly questions, but real parties do not, that isn't so bad. A sanction for not recording that is imposed only when someone else has suffered actual, rather than hypothetical, harm is still a powerful threat, even if it does give the party a better grip in its armwrestling match with the trustee.